COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

D.T.E 03-34

WESTERN MASSACHUSETTS ELECTRIC COMPANY
TRANSITION CHARGE RECONCILIATION FILING

DIRECT TESTIMONY OF DAVID J. EFFRON

On behalf of

THE OFFICE OF THE ATTORNEY GENERAL

January 5, 2004

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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield, Connecticut.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings?

A. I have analyzed numerous electric, telephone, gas and water rate filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in rate case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in approximately two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, and Virginia.

Q. Are you familiar with restructuring and the recovery of transition costs in Massachusetts?

A. Yes. I have presented testimony in D.T.E. 97-120 and D.T.E. 00-33 regarding the recovery of transition costs by Western Massachusetts Electric Company and in D.T.E. 99-110 regarding the recovery of transition costs by Fitchburg Gas and Electric Light Company. As a result of having participated in negotiations, I am also familiar with recovery of transition charges by Massachusetts Electric Company, including the former Eastern Edison Company.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University

II. PURPOSE OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Office of the Attorney General.

Q. What is the purpose of your testimony?

A. I have reviewed the Transition Charge Reconciliation Filing for 2002 by Western Massachusetts Electric Company ("WMECO" or "the Company"). Based on that review, I am proposing certain adjustments to the reconciliation of transition charge revenues and costs by WMECO for 2002. I also address the Company's proposal to apply the cumulative over-recovery of transition charges as of December 31, 2002 by accelerating the amortization of non-securitized transition costs.

Q. Please summarize your conclusions.

A. I am proposing the following modifications to the company's reconciliation of transition charges for 2002: 1) Carrying charges should be compounded annually. 2) The market value of purchased power should be modified unless the Company can explain why the value used in the transition charge calculation is less than the value shown in the FERC Form 1. 3) A revenue conversion factor of 1.6454 should be used to calculate the pre-tax rate of return on equity. In addition, the cumulative over-recovery as of December 31, 2003 should be used only to reduce fixed costs earning a return.

III. TRANSITION CHARGE RECONCILIATION

A. CARRYING CHARGES

Q. Have you reviewed the Company's calculation of carrying charges on the cumulative over or under recovered balance of transition costs on Exhibit JRC-3, Page 1?

A. Yes. The Company provided the supporting calculations for its carrying charges in

the response to AG1-006.

Q. Are you proposing any adjustment to the Company's method of calculating carrying charges?

A. Yes. In calculating the annual amount of carrying charges, WMECO has not included the balance of carrying charges accrued in prior years. For example, in calculating the carrying charges in 2002, the Company did not include the carrying charges accrued in the years 1998 – 2001 in the balance on which the carrying charges are computed. The carrying charges for a given year are a component of the total transition costs, so the calculation of carrying charges in a given year should reflect the cumulative balance of carrying charges for prior years in the balance on which carrying charges are accrued. In other words, the carrying charges should be compounded annually.

Q. Have you calculated the effect of compounding the carrying charges?

A. Yes. On my Schedule DJE-1, I show the calculation of carrying charges, including the carrying charges on the cumulative balance of carrying charges accrued in prior years. As can be seen on this schedule, the effect of compounding the carrying charges annually for the years, 1998 – 2002 is to reduce the net carrying charges accrued in those years by $160,000[1]. As a result, the cumulative over-recovery (assuming all else equal) as of December 31, 2002 is reduced from $28,054,000 calculated by WMECO to $27,894,000. However, the effect will reverse in 2003 and 2004 for two reasons: 1) the cumulative balance of carrying charges turned positive in 2002 and 2) the carrying charges on the 2003 over-recovery[2] will be added into the

[1] This includes the effect of the proposed modification to the pre-tax rate of return in Section C.
[2] The over-recovery in 2003 will likely be somewhere around $20 million.

balance on which carrying charges are accrued in 2004.

B. VALUE OF PURCHASED POWER RESALES

Q. Does the variable component of the transition charge include the above market cost of purchased power contracts?

A. Yes. The variable component includes the above market costs of the Pioneer and Vermont Yankee purchased power obligations. The above market costs are calculated by subtracting the actual wholesale market value of the power from the actual costs incurred for these two purchased power contracts. These calculations are shown on Exhibit JRC-3, Pages 9 and 10.

Q. Has the Company provided supporting data for the costs and wholesale market value of the power?

A. Yes. In response to AG1-016, the Company provided information supporting the costs and wholesale market value of those two contracts. The costs are shown on a monthly basis and reconciled to the purchased power expense in the Company's FERC Form 1. The revenue from the resale of that power is also shown on a monthly basis. However, there is no reconciliation of that revenue to the revenues from sales for resale shown in the FERC Form 1.

Q. Is the wholesale market value reflected by the Company consistent with the value of sales from resale shown in the FERC Form 1?

A. It does not appear to be. On Exhibit JRC-3, Page 10, the wholesale market value is shown as approximately $0.035 per kWh for both contracts in 2002. In the FERC Form 1, the average price per kWh from all sales for resale in 2002 is approximately

$0.052. For sales to ISO New England, the average price per kWh in 2002 is approximately $0.049. The total output from the Pioneer and Vermont Yankee contracts in 2002 was 143,000,000 kWh. The total sales for resale were 180,629,000 kWh, and the total sales to ISO New England were 140,720,000 kWh. Therefore, it would appear that most (if not almost all) of the output from the Pioneer and Vermont Yankee contracts in 2002 went to ISO New England.

Q. Are you recommending any modification to the above market costs of the Pioneer and Vermont Yankee purchased power obligations included in the variable component of the transition charge?

A. Unless the Company can reconcile and explain the difference between the market price per kWh shown on Exhibit JRC-3, Page 10 and the average price of sales for resale in the FERC Form 1, the wholesale market value on Exhibit JRC-3, Page 10 should be modified. As stated above, the average price per kWh of sales to ISO New England in 2002 was approximately $0.049. Using this as the wholesale market value per kWh of the Pioneer and Vermont Yankee power would result in a total value of $7,007,000. This is $1,978,000 greater than the total value of $5,029,000 shown on Exhibit JRC-3, Page 10. Therefore, reflecting a wholesale market value for the Pioneer and Vermont Yankee power consistent with the value of sales to ISO New England, as indicated in the FERC Form 1, would reduce the over-market costs of purchased power contracts included in the variable component of the transition charge by $1,978,000.

C. GROSS REVENUE CONVERSION FACTOR

Q. What is the gross revenue conversion factor?

A. The gross revenue conversion factor is the factor applied to the equity component of the rate of return to state the overall rate of return on a pre-tax basis. It takes account of the income taxes associated with the return on equity.

Q. What gross revenue conversion factor did the Company use in 2002 to calculate the pre-tax rate of return?

A. The Company used a gross revenue conversion factor of 1.6236 in 2002 (Exhibit JRC-3, Page 12A).

Q. Is this different from the gross revenue conversion factor used in other years?

A. Yes. As Exhibit JRC-3, Page 12A, shows, it is lower than the gross revenue conversion factor used in any of the other years from 1998 through 2013 (except 2003, which is the same).

Q. Has the Company explained why the gross revenue conversion factor was lower in 2002 than in earlier years?

A. Yes. In response to AG1-020, the Company stated that the apportionment of the Connecticut state income tax in the calculation of the effective income tax rate was reduced as a result of the sale of the Millstone nuclear power station. However, the Company did not provide calculations to support the state income tax rate of 5.2457% that goes into the gross revenue conversion factor of 1.6236 or explain why the Connecticut state income tax is relevant to a Massachusetts transition charge.

Q. What is the appropriate gross revenue conversion factor based on the Massachusetts and federal income tax rates?

A. Based on a Massachusetts income tax rate of 6.5% and a federal income tax rate of

35%, the gross revenue conversion factor should be 1.6454.[3] In fact, this is the gross revenue conversion factor shown on Exhibit JRC-3, Page 12A for 1998 and for all years after 2003. There are slight differences in the years 1999 – 2001, but not as great as the deviation in 2002.

Q. What do you recommend?

A. I recommend that a gross revenue conversion factor of 1.6454 be used for 2002. That reflects the actual combined Massachusetts and federal income tax rates. It is also consistent with the effective combined income tax rate used in other places in the determination of the transition charge, such as the calculation of the deferred tax balances on Exhibit JRC-3, Page 11B. The use of a gross revenue conversion factor of 1.6454 results in a pre-tax rate of return of 15.05%[4] in 2002.

IV. OVER-RECOVERED BALANCE

Q. What was the cumulative balance of under or over recovered transition charges as of December 31, 2002?

A. As of December 31, 2002, there was a cumulative over-recovered balance of $27,894,000.[5]

Q. Has the Company proposed an application of the over recovery as of December 31, 2002?

A. Yes. The Company has proposed to apply the over-recovery against the transition costs by accelerating the amortization of non-securitized fixed costs. In other words,

[3] Calculated as 1/(1-(.65*.065 + .35))
[4] 1.57% + 1.6454 * 8.19% (Exhibit JRC-3, Page 12A)
[5] This balance reflects my proposed modification to compound carrying charges annually and my proposed adjustment to the pre-tax rate of return for 2002.

the Company is proposing to offset the over-recovery against fixed costs remaining to be recovered as of December 31, 2002. On Page 8 of his testimony, Mr. Cahoon identifies six categories of fixed costs against which the over-recovery could be offset.

Q. Has the Company identified the specific fixed costs against which the over-recovery should be applied?

A. In response to DTE1-002, WMECO stated that it recommends that the over-recovery first be applied to the remaining Millstone Unit 2 fixed costs ($7,090,000 as of December 31, 2002) and then to the FAS 109 regulatory asset.

Q. Do you agree that the over-recovery should first be applied to the remaining Millstone Unit 2 fixed costs and then to the FAS 109 regulatory asset?

A. I agree that application of the over-recovery against the Millstone Unit 2 fixed costs is appropriate, as the Millstone Unit 2 fixed costs earn a return. The Company's recommendation to apply the remaining balance of the over-recovery, approximately $21 million, against the FAS 109 regulatory asset is not completely clear.

The FAS 109 regulatory asset appears in a couple of places in the calculation of the fixed component of the transition charge. First, an FAS 109 balance is included in regulatory assets not earning a return on Exhibit JRC-3, Page 6. Second, there is an FAS 109 balance included in the net fixed cost component earning a return on Exhibit JRC-3, Page 12, Column C(2). If the Company's recommendation entails reducing the FAS 109 balance on Exhibit JRC-3, Page 6 by approximately $21 million and reducing the FAS 109 balance on Exhibit JRC-3, Page 12, Column C(2) by the same amount, then the Company's recommendation is appropriate. The loss of the return on the over-recovery would then be compensated by a reduction to the

return on fixed transition costs. However, it would be improper to simply offset the over-recovery against the FAS 109 balance on Exhibit JRC-3, Page 6, with no further application of the over-recovery.

Q. Why would it be improper to offset the over-recovery against only the FAS 109 balance on Exhibit JRC-3, Page 6?

A. Very simply, this would entail offsetting an interest bearing liability to customers against what is, in effect, a non-interest bearing receivable from customers. The FAS 109 balance on Exhibit JRC-3, Page 6 is a regulatory asset being amortized without a return. Therefore, the present value of that regulatory asset to be recovered as of December 31, 2002 is less than the balance as of that date.[6] On the other hand, the over-recovery accrues carrying charges at the specified rate of return. Therefore, the present value of the over-recovery is equal to the stated balance. Offsetting the over-recovery against the FAS 109 regulatory asset on a dollar for dollar basis would be trading an amount of greater value (to customers) for an amount of lesser value. It would be inequitable to use an over-recovery accruing carrying charges at the pre-tax rate of return to reduce fixed costs not earning any return. Customers would lose the return on the over-recovered balance, with no compensating reduction to the return on the fixed transition costs, as the FAS 109 regulatory asset does not earn a return.

Q. Would it be appropriate to offset the remaining over-recovery against any of the other transition costs listed by Mr. Cahoon?

A. No. Except for Millstone Unit 2, none of the fixed costs remaining after securitization earn a return. No offset to these fixed costs is appropriate unless a mechanism can be established to make ratepayers whole for the loss of the return on

[6] Assuming a discount rate greater than 0%

the over-recovered balance.

Q. Does this conclude your direct testimony?

A. Yes.